TESTIMONY

of

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Thank you for the invitation to appear before you today.

I am Aaron J. Gellman, Professor at the Transportation Center at Northwestern University.

There are five reasons most often given these days for seeking to become a single airline through merger or acquisition:

1. Economies of scale: reduction of costs
2. Economies of scope: there will be more single-line service to more places, especially internationally
3. A varied fleet can be deployed to meet more precisely the needs of each city-pair market
4. High and mounting fuel costs
5. Reduction in the rate-of-growth of the economy.

I will consider each of these "reasons" in turn. But before doing so, I need to state that the views I express today are my own and do not necessarily reflect those of the university, its faculty and staff nor of the Transportation Center at Northwestern University with which I am principally associated. I should also make it clear that I am not categorically against mergers between airlines. There are amalgamations that make economic and public policy sense but, as I shall demonstrate, this is not one of them.

<u>Economics of Scale: Reduction of Costs</u>

I should not be surprised if certain non-flying jobs would be eliminated were NWA and DAL to marry. Some functions are surely duplicated in the two carriers and not all the associated people would be needed in the future. The challenge for a new management team is to assure that the best, most productive, persons are retained while the others, sadly but necessarily, pay the price of displacement.

But the history of mergers in this as well as other industries give little comfort that this will be the case, thus decreasing the prospective cost-savings.

As for other cost-related issues, there would be some benefit from geographically broader, more efficient advertising and marketing programs but airport space rental and maintenance costs are unlikely to be much reduced given the representations of the prospective merger partners not to close hubs or cut services significantly.

The prospects regarding the pilots of the two carriers suggest either a minimal beneficial effect on costs or a substantial increase. In the former case, it will require the two carriers to continue operating essentially as two airlines (much as U.S. Air has had to do). Many economies of scale would be sacrificed in the process but costs attributable to pilots may well not change much.

On the other hand, in order to achieve real and full integration of the two airlines, it will be necessary to bring the pilot corps together through a merger of the two seniority lists on a basis acceptable to both pilot groups, something US Air has still not been able to accomplish. This is likely to be an even greater issue with DAL and NWA.

Assuming the new Delta can do it, this will mean a substantial additional cost burden for some time as seniority number, rather than pilot age or experience, will determine what equipment the pilot can bid for. And given the great, and perhaps unprecedented, disparity of the two airlines' fleets, this will take a considerable period to implement with attendant training and logistics costs all along the way.

Economies of Scope

There are economies of scope to be exploited in a combined carrier. Perhaps this is why there is the pledge in this instance to retain all the hubs now in each system. But how the economies work out from greater scope, and the value of such economies work out from greater scope—and the value of such economies—is not clear, except for the advertising and cost savings previously cited. It should also be noted that one of the principle reasons given for international alliances, in which both carriers already participate, is that they enable airlines to gain many economic and marketing benefits without the need to merge.

Varied Fleet Benefits

A disparate fleet of aircraft is not usually considered productive of economic benefits. To be sure, a variety of aircraft is required to carry out the wide range of missions of Delta and Northwest either individually or combined. But the number of aircraft types must be constrained if all the benefits of economies of scale are to be realized. This means, in the present case, that either one of the carriers has to substantially re-fleet (which would be exceptionally costly and take considerable time) or that, again, the two carriers be operated separately with all that entails. (At present, the only aircraft type flown by both carriers is the 757-200 with Pratt and Whitney engines. Otherwise, Northwest is oriented to Airbus and Delta is exclusively Boeing.)

In any event, presently, each airline alone appears to have a fleet varied enough to assign aircraft types to the markets best suited to them. Also, each carrier has regional jet and turbo-prop operations--either through subsidiaries (e.g. Comair) or through contracts—providing each with even greater flexibility. Therefore to make a virtue of an exceptionally diversified combined fleet seems more of an excuse than a reason to merge.

High and Mounting Fuel Costs and a Slowing Economy

First, again we have excuses being offered as reasons. Regarding fuel, with very limited exceptions, all U.S. Airlines are faced with the same conditions. Moreover, how can the combination of these two airlines influence either "condition"? Only by reducing service can fuel costs be lowered in the short-run and there is the representation this will not be pursued to any significant degree if these carriers combine. (The service cuts that clearly can be made are those where there are directly competitive services; there are few such opportunities in what is predominantly an end-to-end merger as is here proposed.)

But a larger issue must be faced: when fuel prices decline and economic growth is restored, both of which will surely happen, what of these "reasons" then? You will not be able to un-scramble the egg. And if these were not valid bases for consolidating, how much will the public suffer in future because of higher fares and reduced services as a result of the merger having taken place?

I would like to conclude with three, more general, observations. First, the recent withdrawal of Continental Airlines from negotiations with United is of considerable importance in the present context. Note that Mr. Kellner, Continental's CEO, prominently cited "cultural" differences as a reason for not going forward. One has to admire Mr. Kellner for his candor which is of benefit to you and, indeed to all of us, because cultural differences do matter in mergers between firms, especially where they serve the public with a "soft", personal product.

Second, what, if any, has been the role of hedge funds in the present urge-to-merge of several airlines? After all, how can this question be ignored when a fund named Pardus, out of whole cloth, announced to the world some months ago that Delta and United were negotiating, after which both carriers quickly and firmly denied. Was this an attempt to manipulate the share prices of one or both companies? Shouldn't the SEC be alert to the possibility, even probability, that this is an emerging pattern?

Finally, there is the issue of how do you hold the merged firm to the representations made in order to gain approval to join? Will the system be maintained as promised? If not, what, can be done? I don't have an answer. I hope you do.

Thank you for your attention and for the opportunity to appear before you today.